BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE INVESTIGATION OF THE PUBLIC SERVICE COMMISSION INTO REVENUE DECOUPLING MECHANISMS FOR POTENTIAL ADOPTION AND IMPLEMENTATION BY ELECTRIC AND NATURAL GAS UTILITIES SUBJECT TO THE JURISDICTION OF THE PUBLIC SERVICE COMMISSION (OPENED MARCH 20, 2007)	PSC REGULATION DOCKET NO. 59

Initial Comments of Chesapeake Utilities Corporation

On July 6, 2007, Chesapeake Utilities Corporation ("Chesapeake" or "the Company") filed a petition with the Delaware Public Service Commission ("Commission") requesting an increase in base rates and certain other changes to its natural gas tariff. Included in the Company's filing is a proposed revenue decoupling procedure, which would adopt a revenue normalization mechanism similar to the mechanism Chesapeake currently has in place in its Maryland Division. The proposed mechanism would "decouple" the recovery of the Commission-approved revenue requirement for certain rate classes from the variable gas usage of the consumers in the class. Under Chesapeake's proposed methodology, an annual revenue requirement for each rate class would be determined in a rate proceeding such as the base rate case currently filed. At the conclusion of the rate proceeding, the Commission would approve a revenue requirement by rate class, such revenues reflecting a forecast number of consumers and estimated gas usage levels under conditions of normal weather. The Commission approved annual revenue requirement by class would be utilized to determine equivalent normalized monthly base revenues per consumer. The monthly base revenue amount per consumer would be calculated based on the proportional difference in monthly revenue compared to total revenue from the applicable rate classes. Any difference (either positive or negative) between the actual revenue received in a month per consumer and the normalized monthly base revenue requirement per consumer would be multiplied by the number of active consumers in each month. The resulting amount (positive or negative) would be accrued by the Company each month. At the beginning of each calendar quarter, the Company's Gas Delivery Service rate for each rate class would be increased or decreased by an amount

calculated to recover or refund shortfalls or surpluses in the Company's approved normalized revenue requirement from the prior quarter.

Chesapeake's proposal contemplates that this mechanism would be applicable to all consumers using less than 100,000 Ccf per year. The Company has proposed a Demand Charge for all consumers using over 100,000 Ccf per year, which would increase the recovery of fixed costs through a fixed charge.

In conjunction with the proposed revenue normalization mechanism, Chesapeake has proposed an energy conservation plan aimed primarily at the residential home market. There are two primary reasons the Company has linked revenue decoupling to the support of consumer energy conservation programs. First, Companies that fail to understand and meet the expectations of their consumers are generally unsuccessful. It is clear from the Company's experience with its own consumers that homeowners and business owners are concerned about energy costs and are actively searching for methods to conserve. If the Company can decouple its revenues from sales volume, it would be able to actively encourage and support actions that could have a meaningful impact on energy use and a consumer's bill. Over the long-term the Company believes that its ability to retain consumers and grow its business will be based, in large part, on its efforts to help consumers use natural gas in the most efficient way possible.

Second, there appears to be significant interest among numerous parties to directly associate revenue decoupling and other innovative rate designs with energy conservation. Several national environmental and energy efficiency groups have recognized that traditional rate designs are disincentives for gas and electric utilities to support energy conservation efforts. For example, the Natural Resources Defense Council (in this proceeding) and the American Council for an Energy-Efficient Economy have issued statements supportive of decoupling as a means to enlist the utilities support of conservation efforts, including statements provided to the Commission in this docket. Additionally, a number of state regulatory commissions have approved decoupling mechanisms with the stipulation that a utility develop and promote substantive energy conservation programs. The National Association of Regulatory Utility Commissioners ("NARUC") adopted a resolution on *Energy Efficiency and Innovative Rate Design* in November 2005. In its resolution NARUC concluded that, "Current forms of rate design may tend to create a misalignment between the interests of natural gas utilities and their customers." NARUC went on to, "…encourage State

commissions and other policy makers to review the rate designs they have previously approved to determine whether they should be reconsidered in order to implement innovative rate designs that will encourage energy conservation and energy efficiency…" It would appear that linking revenue decoupling and energy conservation is a concept that has broad based and growing support among conservationists, environmentalists, and regulatory agencies across the country.

In April 2007, U.S. Senators Jeff Bingaman and Pete Domenici introduced S.B. 1115. This proposed bill is primarily focused on establishing standards for appliance efficiency, energy use in government buildings and reducing gasoline usage in the transportation sector. However, as an example of the increasing trend among lawmakers and state regulators to link conservation efforts and utility rate structures, the proposed bill includes language urging state utility regulators to consider, "separating fixed-cost revenue recovery from the volume of transportation or sales service provided to the customers" and "adopting energy-efficiency as one of the goals of retail rate design."

Is implementation of revenue decoupling permitted under the Delaware Public Utilities Act of 1974, 26 Del. C. § 101, *et seq.* which contemplates a rate-based, rate of return earnings structure for regulated utilities?

Yes. As mentioned in the legal analysis submitted by Chesapeake's legal counsel on August 15, 2007, revenue decoupling mechanisms do not represent a departure from rate base or rate of return regulation. Revenue decoupling is not designed to allow a utility to earn a rate of return in excess of that determined by the Commission to be a fair rate of return. In addition, decoupling mechanisms, as is the case with all rate design options, would provide no guarantee that the utility could earn even its authorized rate of return. Decoupling is a revenue mechanism that is not designed to track or recover the utility's actual operating costs. Decoupling does not reduce the utility's current incentive to efficiently manage its business and control operating costs. While revenue decoupling normally involves the use of a "tracker" mechanism, such mechanisms have been used by the Delaware Public Service Commission in the past for the recovery of expenses such as environmental clean-up costs and local franchise fees. The Delaware Public Service Utilities Act does not prohibit revenue decoupling or the use of "tracker" mechanisms.

How will the imposition of a revenue decoupling rider impact examination of a utility's earnings, revenues, assets in the context of rate based, rate of return ratemaking? Is decoupling inconsistent with the premise of rate regulation?

Chesapeake does not anticipate that the existence of a revenue decoupling mechanism will have any substantive impact on the examination of a utility's earnings, revenues, or assets in the context of rate based, rate of return ratemaking. Decoupling would not change the Commission's traditional base rate proceeding practices. Revenues derived from a decoupling mechanism would be treated no differently than revenues derived from any other rate design option in the context of a rate proceeding. As noted above, the utility will continue to have a Commission approved revenue requirement for each rate class. The recovery of that revenue requirement through a Commission approved decoupling rate design is entirely consistent with traditional rate regulation. Revenue decoupling is not designed to allow a utility to earn a rate of return in excess of that determined by the Commission to be a fair rate of return.

From a public policy viewpoint, is it appropriate to compensate utilities for decreased revenues? Is it appropriate to compensate utilities for decreased revenues that result from consumers' conservation efforts?

Virtually all costs associated with operating a gas utility are fixed, that is the costs do not change as the volume of gas used by consumers goes up or down. The Company recovers its costs, including a return on its investments, by charging for the "delivery" of gas over its pipeline distribution system. The only significant variable cost for the Company is its gas supply commodity costs. That cost is passed through to consumers through the existing Gas Sales Service Rate ("GSR") mechanism with no mark-up by the Company. Gas supply commodity revenues do not contribute to the recovery of the Company's fixed operating costs.

Under traditional rate design practice, the annual cost to provide delivery service to consumers is divided into the estimated volume of gas for each customer class forecasted to be delivered in the same year, and a sales rate per unit delivered (a volumetric rate) is derived. If the Company delivers more or less gas than forecasted, it will (other factors being equal) either over-recover or under-recover its projected costs through the application of the volumetric rate. In the event consumers use less gas than forecast due to conservation, the utility's profits suffer, since the recovery of fixed costs through volumetric rates is reduced proportionately to the reduction in consumption. The

conservation efforts of consumers prevent the utility from recovering its Commission authorized revenue requirement. Given that the revenue requirement is designed to cover the utility's operating costs and provide an opportunity to earn its allowed return, reductions in consumer consumption have a negative impact on earnings. Under a volumetric rate design, energy efficiency and conservation by consumers, while good for the consumer and society as a whole, are not compatible with the Company's shareholder interests. Decoupling mechanisms break the link between revenue and consumer consumption, and help re-position the utility to take an active role in the support of conservation efforts without negatively impacting its ability to recover costs and achieve a reasonable, Commission authorized return. If the policy makers believe it is important for utilities to play an active and aggressive role in promoting conservation, it is appropriate to remove the disincentive by the use of a rate design that allows the utility to adjust its rates based on reductions in customer use.

What effect, if any, will the implementation of a revenue decoupling mechanism have on the frequency of future base rate proceedings?

Chesapeake anticipates that the implementation of a revenue decoupling mechanism could reduce the frequency of future base rate proceedings. Without revenue decoupling, if the utility's revenues are less than the test period revenues due to customer conservation efforts, the only way for the utility to adjust rates would be to file a rate case. Revenue decoupling would adjust rates to take into account different consumption levels without the necessity of a rate case and without allowing the utility to earn a return in excess of that approved by the Commission. However, as noted above, decoupling does nothing to impact the level of costs that the Company will incur to provide service. Therefore, increases in the operating costs of a utility will continue to have an impact on its achieved rate of return, and the need for future rate proceedings.

Do all utility customers benefit from a revenue decoupling mechanism? How do utility conservation and efficiency efforts overcome market barriers faced by subsets of customers, such as renters, customers who cannot take on more debt, low-income customers, small business, etc. and to what extent will such customers participate in and benefit from such utility efforts? In light of the potential benefits to participating customers and to non-participants (i.e. system benefits, and they may be allocated), can all customers benefit equally from

conservation and efficiency efforts induced by revenue decoupling? If not, can all customers receive some degree of benefit? If not, will any customers lose the anticipated benefit entirely? If not, is revenue decoupling and the anticipated resulting energy efficiency and conservation efforts nevertheless justified?

All consumers benefit when utilities are able to stabilize revenues. Revenue decoupling mechanisms of the type under consideration in this docket can streamline and reduce the costs of regulation. Consumers benefit if utilities can postpone rate proceedings and the costs of those proceedings. To the extent a utility's financial condition is improved through stable revenues, increased investment in customer additions may be possible. All consumers benefit when the utility's fixed costs are spread over a larger customer base. Decoupling would encourage utilities to actively support conservation activities. While Chesapeake is not in a position to quantify the societal benefits (environmental, political, etc) that reductions in gas usage would produce, it is reasonable to expect that all citizens would benefit.

The market barriers to effective conservation efforts outlined in this question will be present for any program regardless of whether it is administered by a utility or third party. Chesapeake administers a substantial energy conservation program in its Florida Division, under the oversight of the Florida Public Service Commission. The program is directed toward residential new construction, residential appliance replacement (electric to gas), residential appliance retention (gas to gas) and certain commercial applications. The new construction program is by far the most successful as measured by the number of residences participating in the program. These results are not unexpected. Utilities across the country invest significant resources to develop relationships with residential and commercial builders and other industry suppliers (plumbers, HVAC installers, equipment distributors, etc.). These relationships translate into access to the building industry as credible experts on energy products. Supported by conservation rebates and other incentives, a utility's sales force can leverage its building industry relationships to have an immediate and measurable impact on the efficiency of new homes. Utilities can also have a significant impact on existing building conservation through its customer relationships and contacts with the trade groups mentioned above, although Chesapeake's experience would indicate a lower overall penetration rate in existing buildings than for new construction.

The conservation programs administered by Chesapeake's Florida Division, and proposed in its rate filing, are primarily straightforward, easily administered cash rebates

to consumers or builders for the installation of high efficiency appliances. The Company also engages in substantial consumer and building trade conservation education programs. None of the programs administered by Florida utilities (gas or electric) are directly aimed at renters or low-income consumers. There are other generally non-utility administered conservation programs operated by governmental and charitable organizations. These programs are primarily aimed at residential weatherization and the promotion of renewable energy technologies.

Chesapeake believes that the most effective conservation initiative for Delaware will ultimately involve a joint effort between utilities, governmental and third party entities. As evidenced by the proposed programs in its rate filing, Chesapeake is willing to actively promote, and administer, conservation and energy efficiency programs in conjunction with revenue decoupling. It is unclear whether conservation programs can be devised that guarantee direct benefits to all subsets of customers. However, in Chesapeake's view that does not diminish the need to establish effective programs that will achieve measurable energy savings. Revenue decoupling would pave the way for Delaware's utilities to support and encourage participation in such programs without harming their shareholders.

Are revenue decoupling mechanisms feasible for both natural gas and electric utilities?

The Company believes that some form of a revenue decoupling mechanism would be feasible for both natural gas and electric utilities; although Chesapeake believes that the exact mechanism would not need to be the same for each. Additionally, any corresponding energy efficiency and conservation programs would not be the same for both natural gas and electric utilities.

Is revenue decoupling appropriate for utilities with investments in supply sources (that will reap savings from avoided supply needs) and for those without such avoidable costs?

Chesapeake has no direct investments in gas supply sources. Chesapeake does manage a "portfolio" of gas supply and interstate pipeline capacity agreements designed to provide reliable commodity deliveries to its sales customers. Any supply-related cost reductions resulting from decreased usage due to conservation, or any other reason, would continue to be passed through to consumers in the Company's

Commission authorized Gas Sales Rate (GSR) mechanism. It should be noted, that the relationship between conservation and gas supply requirements is complex and difficult to forecast. A utility's (or gas marketer's) gas supply and capacity portfolios are designed to ensure reliable gas deliveries during both average and peak usage conditions. Conservation efforts may lower overall gas use, but have minimal impact (at least in the short term) on peak requirements. For example, the installation of a high efficiency furnace should, all things equal, reduce a consumer's total gas consumption, yet may have little impact on the demand for gas under peak day weather conditions. Chesapeake holds quantities of pipeline capacity and maintains a variety of baseload and swing service gas supply options to handle both average and peak day requirements. In Chesapeake's view, the adjustment of supply and/or capacity portfolios to reflect actual or forecast reductions in annual volumes related to conservation must be measured against other factors that contribute to the demand for gas, e.g. weather, customer growth and economic concerns. In addition, consideration should be given to other options that may have greater and more immediate impact on consumer supply related costs and less overall reliability risk, such as the unbundling proposal Chesapeake included in its recent base rate filing. Increasing the use of third party gas suppliers to serve consumers will, in Chesapeake's view, lead to greater optimization of pipeline capacity assets to the ultimate benefit of consumers.

How can the utility quantify the impact of utility energy efficiency, conservation efforts and the supposed impact on utility revenues? How can the utility quantify and isolate the impact of utility energy efficiency, conservation efforts and the supposed impact on utility revenues from other factors, such as the normal business risk of warmer weather, etc.?

Chesapeake believes that there should be a standardized process for quantifying the impact of energy efficiency and conservation efforts on utility revenues. The Company is open to discussing ways to develop such a mechanism.

Should such a mechanism be limited to the residential and commercial customer service classes? Why or why not.

Chesapeake has proposed that its revenue normalization mechanism be applicable to all customers with annual usage below 100,000 Ccf. The Company has proposed a Demand Charge for customers with annual usage over 100,000 Ccf in the

absence of a revenue normalization mechanism. Chesapeake has not included its largest customers in its proposed mechanism as it does not believe their consumption is as significantly impacted by conservation and other factors. Additionally, with a Demand Charge, the Company is not as dependent upon the volumetric rate in order to recover its costs.

What impact does implementation of a revenue decoupling mechanism have on a utility's risk for sales fluctuations and associated revenues?

Chesapeake believes that the implementation of a revenue decoupling mechanism reduces the volatility in revenues resulting from conservation efforts and weather. It is not designed to track or recover actual operating costs.

What adjustment(s) should be made to a utilities' approved return on equity (in terms of basis points) when it imposes a revenue decoupling mechanism?

Chesapeake does not believe that any adjustment should be made to a utility's return on equity as a result of a revenue decoupling mechanism. The return on equity for a Company is calculated through market-determined models. For example, in the group of utilities used to approximate Chesapeake's proposed return on equity for its pending base rate case, six of the companies already have some form of revenue adjustment mechanism and one remaining company has a weather mitigation rate design intended to deal with the effect of weather volatility during the months of December through May. Therefore, the market prices of these companies' common equity reflect the expectations of investors related to a regulatory mechanism that adjusts revenues. Issues related to rate design are traditionally not considered in establishing a utility's authorized ROE.

How will the revenue decoupling mechanism affect intra- and inter-class allocations in future cost of service studies and rate design within the context of a base rate proceeding?

Chesapeake does not anticipate that the implementation of a revenue decoupling mechanism would have any impact on intra- and inter-class allocations in future cost of service studies. Cost of service studies are designed to determine the cost a utility incurs to serve a particular rate class and this cost is typically not linked to the actual amount of revenue received.

Does a rider rate decoupling mechanism send the appropriate price signal to customers when the delivery end portion of their bill goes up even though they are making the effort to conserve? Recognizing any savings would come in the commodity portion of the bill, all things held equal.

Yes. Gas utility bills are generally separated into two components; delivery service and gas commodity service. Only the delivery service portion of a residential consumer's bill would be subject to revenue decoupling (39% of a typical Chesapeake customer's bill). The gas commodity portion and other variable components of a customer's bill vary with energy conservation efforts (61% of a Chesapeake customer's bill). Therefore, the savings a consumer will experience on the commodity portion of the bill would be expected to outweigh any increase on the delivery service portion.

Is declining usage offset by an increasing customer base, such as by expansion in areas like Sussex County?

Declining consumption per customer is not off-set by an increase in customers such as by an expansion into an area such as eastern Sussex County. The cost Chesapeake incurs for a particular customer is fixed, it is not dependent upon the consumption of that customer. In Chesapeake's recently filed base rate case, it has included test period consumption per customer of 612 Ccf per year for a residential customer. If the consumption per customer were to decrease 25% to 459 Ccf per year, the impact on the Company's gas delivery revenues would be over $1.6 million. At that rate, Chesapeake would need to add 3,655 new customers per year at its proposed expansion revenue level of $440 per customer in order to make up the shortfall. Given that it is not reasonable to expect sustained annual customer additions at the above level, the Company could not offset the declining usage of the Company's entire customer base through customer additions.

In addition, utilities that invest in main extensions for the purpose of expanding distribution systems to serve new areas usually experience downward pressure on their returns. In most cases, development in these projects follows a predictable pattern. Initially residences are constructed and, over time, commercial businesses are added to provide services to the residents. It is rare that a large anchor load such as an industrial plant or electric generating facility that could support a lengthy pipeline extension is constructed close to the residential area. Given the relatively low gas margins for

residential customers and the extended buildout period of most development projects, it is especially critical for the utility to achieve the revenue requirement authorized by the Commission. As an alternative to decoupling mechanisms, such as the revenue normalization mechanism recently proposed by Chesapeake, some utilities have received approval for rate stabilization mechanisms. These mechanisms recognize that negative impact on utility returns related to system expansion (and certain other) investments, and provide an adjustment to rates, without a full rate proceeding, that enables the utility to earn an authorized target return.

To date, what evidence has there been that customers' energy conservation efforts have resulted in decreased revenue for the affected utilities?

Over the past twenty-five years, the natural gas industry in the United States has experienced a significant growth in customers and a concurrent significant reduction in gas consumed per customer, especially in the residential market. According to an American Gas Association (AGA) study, today's average American home uses 25% less natural gas than in 1980. The Company's experience in its Delaware Division is similar to the national trend. The Company is recording steady declines in usage per consumer, especially among mid-volume commercial and residential consumers. These reductions in usage are the result of several factors. Increases in the efficiency of appliances and improvements in building construction standards have been key contributors. In addition, the general increase and volatility in fuel prices in this decade has given consumers incentive to reduce their energy use. Information compiled by AGA indicates that homeowner conservation efforts have accelerated. Over the past five years, homeowners have reduced gas consumption even more than the 1% per year trend experienced over the previous twenty years. Similar trends have been seen in non-residential markets. National policy makers however believe that there is much room for improvement in the area of energy conservation. Accordingly, utilities are being urged to take a more aggressive role in promoting conservation. Revenue decoupling would remove a utility's disincentive to aggressively promote conservation.

What history should the utility have of promoting energy efficiency and conservation *before* it is allowed to impose a revenue decoupling mechanism?

It is not reasonable to expect a utility to actively promote energy efficiency and conservation efforts prior to the implementation of a revenue decoupling mechanism. If

a utility begins to implement adequate conservation programs, it should not be penalized financially for a pre-determined and arbitrary period of time if the programs are successful. As noted above, however, Chesapeake has a long history (over 20 years) of administering energy conservation programs in its Florida Division.

How will utilities prove that it is exclusively their efforts to promote conservation that have resulted in lower revenues versus programs implemented by the State's Energy Office, private advocacy groups or some other governmental agency? What is the impact of revenue decoupling on the efficiency programs proposed by the Sustainable Energy Utility ("SEU") Task Force?

It is not necessary for Chesapeake to be able to determine whether or not it is its energy efficiency programs or a combination of programs that will result in lower levels of consumption per customer and lower revenues for the Company. The goal of a revenue decoupling mechanism is to allow utilities to align with other advocacy groups and state agencies in promoting energy and conservation programs, without a negative financial impact.

Chesapeake believes that its proposed conservation programs would also be a good fit with the conceptual structure of the SEU as included in the report to the Delaware Legislature from the SEU Task Force. The report emphasizes the need to improve building energy use and promote customer-site renewable energy. The framework, as depicted in Figure 4.1 of the report, would include utilities as an integral part of the SEU's operations and implementation functions. In general, utilities, including Chesapeake, have long-established and well developed relationships with developers constructing new residences and commercial properties, retail appliance dealers and contractors. As noted in the SEU report, education and outreach efforts and incentive programs are among the implementation functions that could be provided by utilities. In the Company's view, one of the most expedient and cost effective means of achieving increased energy efficiency in new buildings is through implementation of utility incentive and consumer education programs. The types of programs, delivered effectively by a utility, through its leveraged relationships and service nexus with the new building construction market, are appliance rebates, home energy rating programs, appliance dealer incentives and educational programs for the building industry.

What other approaches can be considered to encourage the utility to promote energy efficiency and conservation? Consider mechanism such as lost base revenue recovery, incentives for superior performance, a return on funds invested in efficiency, some addition to the authorized return on equity, additional assurance of cost recovery through rate design such as increased customers charges and higher initial block rates. Are there other alternatives to a revenue decoupling rate rider that would better promote energy efficiency and load reduction in Delaware?

There are a variety of other rate design and tracking mechanisms that can accomplish the same objective as the Company's proposed revenue normalization mechanism. They include the following:

1. Straight-Fixed Variable ("SFV") Rate Design: Used extensively by the Federal Energy Regulatory Commission ("FERC") for interstate pipeline rate design, SFV rates recover the predominant fixed costs through fixed reservation or demand charges and the lesser variable costs, if any, through a volumetric charge. Utilities in Georgia, North Dakota and Oklahoma currently operate under a SFV-type rate design.
2. Fixed Delivery Service Charge: All costs are recovered from a fixed monthly charge. Atmos Energy's Missouri division recently implemented a fixed charge mechanism for certain small volume rate classes.
3. Rate Stabilization Mechanism: A tracking mechanism that enables a utility to adjust rates, without a full rate case filing, in the event an approved earnings target is not achieved (or is exceeded). Rate stabilization mechanisms are currently in place for utilities operating in South Carolina, Alabama, Mississippi, Louisiana, Oklahoma and Texas.

In addition, the incentive mechanisms mentioned in this question may provide reasonable alternatives that promote conservation without negatively impacting returns. Chesapeake is willing to explore any of the above opportunities as part of its participation in this docket and its current rate proceeding.

Assuming that a revenue decoupling rate rider is appropriate in Delaware, how should it be implemented? On a pilot basis?

Chesapeake does not believe that a pilot program is necessary as rate design issues are reviewed during each base rate proceeding.

What can we learn from the New Jersey Board of Public Utilities' CIP about revenue decoupling that has relevance to our proceeding in this docket? Are there any rules or regulations that have been promulgated by the Board that should be considered in our proceeding?

Chesapeake believes that it can better comment on the New Jersey program following the conference call scheduled for August 27, 2007.